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**THE
COMPLETE**

BREAKOUT TRADER

**Day Trading Strategies
that Work**

JOHN CONNORS

The Complete Breakout Trader:

Day Trading Strategies that Work

John Connors

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“You need only one setup to make a living.”

- *Linda Raschke*

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Dedication

To Linda Raschke, for her mentorship. I wouldn't be where I am today without you.

Introduction

A trader really needs only one setup, one strategy, to be successful. The setup you choose is absolutely crucial to your success. Some setups do not occur frequently enough, or are too tough to trade psychologically. Others are not universal enough, and work only occasionally on some instruments. And still others do not give you enough profits for the risk taken, or are too complex to execute under live market conditions.

Breakout trading does not suffer from any of these defects. It is a simple, comprehensive trading method that you can use in all markets, with potential profits far outweighing the risks.

Some of the most profitable traders in history, early and recent, were breakout traders: they would take a position immediately when they felt a trend has started.

Perhaps the most famous trader of all time, Jesse Livermore, would take a position once the markets broke out and started trending, staying away from range price action. Consider what he says in his now famous reminiscence:

“The thing to do is to watch the market, read the tape to determine the limits of the get-nowhere prices, and make up your mind that you will not take interest until the price breaks through the limit in either direction.” (Reminiscences of Stock Operator, 140).

Livermore did not wait for pullbacks either:

“I never buy on reactions or go short on rallies.” (How to Trade in Stocks, 20).

He would take a position once he has satisfied himself that the market left a price range and started trending. He was a breakout trader.

Nicholas Darvas, another trading legend, the author of “How I Made \$2,000,000 in the Stock Market”, says:

“My only sound reason for buying a stock is that it is

rising in price. If that is happening, no other reason is required. If that is not happening, no other reason is worth considering.”

And in recent times, the Turtles became famous as systematic breakout traders, making millions in the commodities markets.

Breakout trading is a great way to go if you are looking for a tested and a profitable trading method.

What is Breakout Trading?

Breakout trading can be summarized as getting in once the market starts moving, and getting out when it stops. While simplistic, this is the epitome of successful trading. You cannot make money when the market doesn't move. And the best place to get in is right at the start.

Yet, breakout trading seems to have a bad name nowadays. Popular writers like Al Brooks continue to teach that 'most breakouts fail', so it's a bad idea to trade them.

'Wait for a pullback,' they say.

The problem is that many strong trends don't have pullbacks, or have pullbacks that are late, offering lesser profits. It can drive a day trader mad waiting for a pullback in a strong trend that never happens, while the price skyrockets. It isn't logical to identify a trend start and not enter, waiting for a specific chart pattern

to form that may never materialize.

The trends on long-term charts and short-term charts look the same, and they are both tradable. But you don't need to trade long-term timeframes to be a breakout trader. In fact, the difference is that a day trader has many more opportunities. A long-term timeframe trader may catch a trend perhaps only 1 or 2 times a year. A day trader may get an opportunity several times a week. In fact, jumping on a strong, new trend at the start is the easiest way to make money in the markets.

So the question isn't if one should enter a trend. The question is how and when. This book provides you with the best strategy for doing so.

Understanding Modalities

Market

By far, the most important skill you can develop as a trader is understanding the market modalities. This refers to being able to recognize whether or not the market is trending. If it is, there is lot of opportunity.

Don't say: "I know all that". The truth is that most traders know that, yet over 90% lose money consistently.

Why?

It's because they don't have a well-defined method for determining the market modality and sticking to it.

Consider the following:



Chart 1: Range Breaking into Trend

For some time, the market has moved within two, well-defined price points. The price has oscillated between the support at the bottom and resistance at the top.

When the price moves this way, the market is not trending. It is in a range.

After some time, the price broke strongly through the support and a trend has begun. Notice the red bearish bar that strongly broke the range rectangle. It has closed 'out of the box' and had a size larger than any previous bars in the chart.

Now consider this situation:



Chart 2: Range, Bloody Range

Where is the trend? Where is the breakout?

There isn't one. The price is *still* moving within two boundaries. (There may be a trend on a higher timeframe, but that's another matter that we will

consider later.)

Your job as a breakout trader is to get in once the range is broken, and a trend begins. When the market is still ranging, as in Chart 2, your job is to wait.

Because trends begin as breaks out of ranges (breakouts), the first skill to master is to identify the market modality. Is the market trending? If not, where is the range? In other words, between which two points has the price been moving recently? You can easily do that by drawing a price rectangle. The top and the bottom should be touching one or several points. Do that on the charts you trade. The rectangle will serve as the primary reference point for the breakout.

Entry

Definition: we enter on the close of a strong bar that has closed outside of a recent price range (outside the price rectangle).

What to Look For:

1. A well-defined range.
2. A strong breakout bar that closes outside of that range.
3. The entry bar should be bigger than the bars in the range but not climactic, and have a strong close.

All three entry criteria are important, but the most crucial one is #3. The break out of the range must be clear and convincing (the bar should be bigger than previous bars), but not climactic (the bar should not be disproportionately big).

Let's look at some examples.

Examples:



Chart 3: Entry on bar 1.

In chart 3, the entry happens on the close of bar 1. The rectangle indicates the recent price range. Bar 1 has strongly broken out of the range and closed outside. Notice that the bar has a larger body than any of the bars in the range, and that it has a tiny wick at the bottom, indicating strong selling pressure into the bar close.

Also notice that we don't care what market or timeframe this is. You will find this pattern across all instruments and all timeframes.



Chart 4: Entry on bar 2 close.

In this case, bar 1 closed outside, but simply wasn't strong enough. So we enter on the close of bar 2, which is a convincing breakout bar. Again, notice the strong close, size of the bar, and in this case, no wick at the bottom of the bar, indicate very strong selling pressure into the close.

So far so good. You define the range, and then enter on the close of the bar closing outside of it.

Now consider the following chart:



Chart 5: Entry?

Chart 5 has a well defined range. Bar 1 breaks out of that range and closes high. Is this a good entry?

No, it isn't. There is a difference between a trend and a spike. Bar 1 in Chart 5 is a spike, not a trend start. Spike is a sharp market move, too far too fast, typically with a poor entry for you. If you bought the close of bar 1, you would be buying too far outside of the range. Bar 1 is disproportionately big relative to previous bars. Don't enter.

Let's look at one more case:



Chart 6: Enter on bar 1?

In Chart 6, is bar 1 a good entry?

No, it isn't. That's because the price is extremely close to the range, right at the border. You want to price to move away from the range before you enter. Think of the range as a gravity field. It tends to pull price back in, unless there is a strong takeoff. Bar 1 is not a strong take off. The close of Bar 2 is the proper entry.

Advantages

The greatest advantage is that you get in at the start of a trend. This means you are enter at a great price, and can hold your position for large profits.

Disadvantages

The greatest disadvantage is that you will sometimes enter on a breakout that will not develop into a trend (false breakout – fakeout). Consider the following chart:



Chart 7: Fakeout

In Chart 7, the rectangle defines the range. Bar 1 is a break out bar. But, after the entry, the trend has no

follow through, and falls back into the range. Sometimes, this will happen. There are no perfect setups that work 100% of the time.

(Though in this case, **you should have noticed that bar 1 did not have a larger body than any of the bars in the range, which might have warned us that this setup is not good.** When you look at a chart, you want the breakout to be dominant and the range look puny. In this case, the range looks vast and the breakout is miniscule in comparison. Whether the setup is likely to work is all in the details.)

This leads us to a very important question: where do we exit?

Stop Loss

How do we know when the trade hasn't worked out? Clearly, the trade isn't working if the price has reverted back into the range. Typically, strong trends will never return to the range from which they started.

Sometimes, the market will test the range and even penetrate it a few ticks before it takes off. So your stop should be inside the range at least a few ticks. I recommend a stop 10 to 15% inside the range. This way, you will not be shaken out easily, but will get taken out when it is clear the trend has failed.

As an example, consider the following chart:



Chart 8: Stop Placement

In Chart 8, we enter on the close of bar 1 as the price breaks out and closes strongly outside the range. We place the stop 10 to 15% inside the range, choosing a point that would show that our trade hasn't worked out.

Take Profit

The most difficult problem in trading is: where do we take profits?

Good trends have large moves, typically larger than most traders imagine or anticipate. If your stop loss is one unit, how big should be your profit?

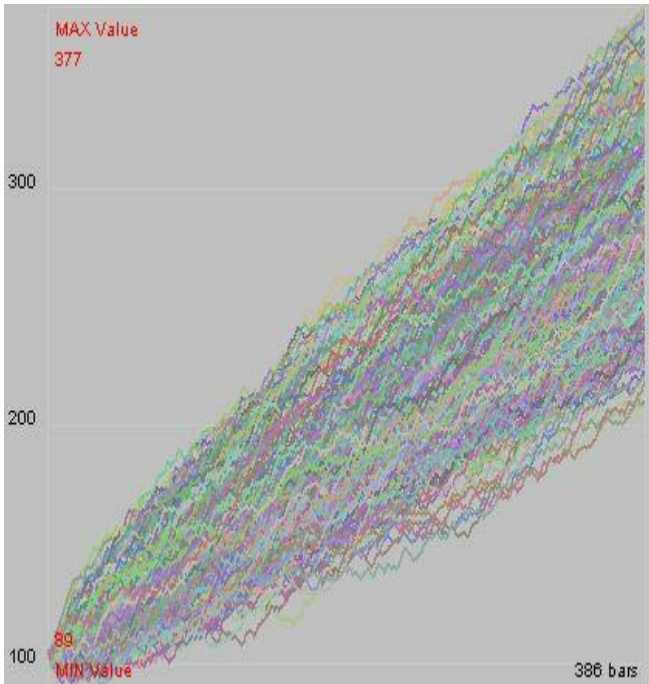
When you catch a great trend, you want to be paid more than whatever it is you are risking. If you are risking 1 unit, I suggest that your minimum take profit point should be 2 units. If you are risking 15 ticks, your take profit point should be 30 ticks away from your entry, and so on.

So considering the previous chart, we would have the following:



Chart 9: Take Profit Point at Twice the Distance from Stop

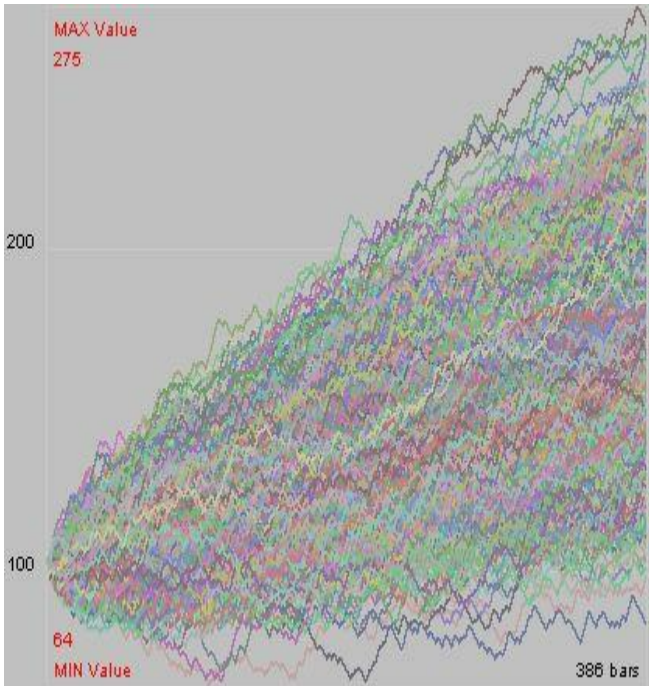
How will this work out in practice? Suppose that your profits are twice as big as your losses and that you win on 50% of your trades. Here's the result of an equity simulation using those parameters, running 1000 trials, starting with equity 100:



**Simulation #1: 1000 trials, 50% Winning Trades,
with Wins Twice as Large as Losses**

In other words, if you can achieve 50% winning rate with those parameters, you are doing fantastic. Your account will grow at a steady pace.

For comparison, suppose you win only on 40% of your trades.



**Simulation #2: 1000 trials, 40% Winning Trades,
with Wins Twice as Large as Losses**

The equity curve is still generally slopping upwards, though not as sharply. Factoring the transaction cost into the equation is likely to make 40% win rate a break-even proposition.

So trading in a way where your profits are twice as large as your losses, you will want to aim for 50% hit rate. Practically, this means taking only trades where all the entry criteria are met, and then managing the position strictly according to your plan. Trading is a game of small edges, and to succeed, you need to minimize mistakes and to follow your plan 100%.

The Art of Catching Monsters

As you evolve, you will start trading more than just the minimum position. For instance, as a futures trader, you will trade more than one contract. The first one you can exit as described above: at twice the size of your risk.

What about the other half of your position?

After taking money off the table with the first half, you should consider the second half as a runner. The problem is nobody has any idea how far it will run. Consider the following chart:



Chart 10: Who imagined?

In Chart 10, if you entered on the close of bar 1, would you imagine how far the trend would run?

There are several ways that you can catch monsters.

After the first half of your position is closed with profit, move your stop to breakeven. You want to take a free position, meaning risking nothing while having a potentially unlimited upside.

Notice how in chart 10 the EMA(20) (Exponential Moving Average, Period 20) held the trend.

Often, EMA acts as a support / resistance in a trend. The trends that run far sometimes do not touch the EMA for a long time, sometimes pushing into the day close.

So exit the rest of your position at the end of the day (bar 2 on chart 10), or when a bar closes on the other

side of the EMA, as in chart 11:



Chart 11: Exit when a bar closes on the other side of the EMA (20).

In Chart 11, we enter on bar 1 close. Bar 2 signaled an exit when it closed below the EMA.

This exit strategy is very robust, and you will catch some monster runners.

How to Improve Your Trade Success Rate

One thing you can do to improve your success rate is to consider a larger context. In other words, look at the market you are trading on a higher timeframe. If you trade 5 minutes, look at a day chart. If you trade 30 minute charts, look at a week chart.

Suppose the higher timeframe looks like this:



Chart 12: Hints from a Higher Time frame

Looking at Chart 12, larger context indicates that the market is in a very strong uptrend. Should you be taking short setups?

Probably not, even if it looks perfect. You should feel hesitant trading against strong trends that exist on higher timeframes. That's because the chances of your trade going far against a bigger, stronger trend are not good. Don't piss against the wind.

Taking breakouts only in the direction of a larger trend can easily be the difference between success and failure in your trading career.

Pitfalls to Avoid

There are really only 2 major mistakes you can make:

- Taking poor setups.
- Mismanaging the trade once you are in.

You cannot afford to take poor looking setups. For a setup to be good, all criteria must be met. In other words, the range has to be defined, and the break out of it has to be clear and strong, but not a spike.

In terms of the trade mismanagement, the two biggest mistakes are moving the stop to book small profit and not holding for a monster with the second half of your position.

So commit to taking only great setups, and make up your mind to manage the trade according to fixed rules

before you get in. Trading time should be only about execution. You shouldn't not be 'thinking' or coming up with new rules or strategies while trading.

Where to Go From Here

If you have completed the book, and understand the materials, it is time for you to go through the charts of your favorite instrument(s).

Mark them up.

Identify the ranges and the breakouts.

Consider the setups. Look for subtle differences between good and poor setups. Save the charts. Create a folder with “Good setups” and “Poor setups” on your desktop. Look through the folders every day. This way, you are solidifying your understanding and learning what works and what doesn't.

Before you start trading the strategy live, I strongly recommend demo-trading. You should not be putting any real money at stake until you have become successful on the demo. I suggest a minimum of 1-month breakout trading on your favorite instrument

before you go live. At the end of the month, you should be profitable using a consistent set of rules. And remember, you need to master just one strategy to make a living!

Happy Trading! :)

“The secret ingredient is you.”

- Kung Fu Panda

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